Pakistan's Economic Prospects and Challenges[1]

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Pakistan is currently undergoing a dangerous and complex military and political crisis that will have negative implications for its economy and which makes economic assessment and prediction very difficult. Explosions have rocked major cities recently and the Pakistani army has just launched an offensive in the Taliban stronghold of South Waziristan. The battle against Islamist militancy is unlikely to be won quickly or easily, so national security is likely to remain the most pressing issue on the domestic political agenda for some time. The fate of the country hangs in the balance.

Pakistan's leading politicians continue to spar, despite the gravity of the challenges facing the nation. President Asif Ali Zardari has repeatedly been attacked by opposition leader Nawaz Sharif and political games continue to be played, to the detriment of a functioning system of democratic government.

The volatile political and security situation has undermined economic confidence and complicated policy making. Military operations in the Swat Valley earlier this year resulted in nearly three million internally displaced persons (IDPs). The security situation remains grave in other parts of the Northwest Frontier Province, Baluchistan, the tribal areas, and major cities. Supporting IDPs and carrying out reconstruction in the areas affected by military operations are major challenges to be faced in the near future.

Despite shortcomings in decision making and policy implementation, Pakistan's economy has continued to stabilize. The IMF reported after its August review that reforms in the financial sector and the foreign exchange market have progressed broadly as envisaged, while steps have been taken to strengthen the social safety net. Revenue mobilization efforts, however, have proven inadequate, as tax policy and tax administration reforms have been delayed. The Fund warned that the macroeconomic outlook remains difficult and the external position is exposed to substantial risks. The Economist Intelligence Unit (EIU) believes that the government's attempts to make further improvements in economic stability will be impeded both by the unfavorable international economic environment and by a range of domestic factors. The task of the government and the State Bank of Pakistan (SBP, the central bank) will be simplified to some degree, however, by the fact that these institutions are now beholden to the IMF and thus have lost much of their policy-making autonomy.

Recent economic growth has been anemic and the near-term outlook for growth remains dim. A rebound in agriculture on the back of a bumper wheat crop helped keep the GDP rising in FY 2008/09 (July-June), but weakness in large-scale manufacturing and exports caused the estimate of real GDP growth to be lowered in 2008/09 from 2.5 to 2.0%. Moreover, an earlier official estimate that real GDP grew at 5.8% in 2007/08 has been revised downward to 4.1%,

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indicating that the economic slowdown began before 2008/09. The EIU forecasts that real GDP will expand by 2.7% in 2009/10.

The global financial crisis has provoked a liquidity crunch in Pakistan. This has curtailed investment, a crucial driver of economic expansion during the boom years from 2004/05 to 2006/07. The government's need to contain the fiscal deficit means that public consumption expenditure also will be significantly curtailed. Private consumption will provide some support to the economy. The EIU expects economic expansion to accelerate to 3.9% by 2010/11, driven largely by resumed growth in investment as financial constraints ease.

The rate of inflation is declining, but more slowly than in many other Asian countries. Although the pace of inflation has been slowing since November 2008, consumer prices in July 2009 were still 13.3% higher than a year previously. Food price inflation is still high while fuel and lighting prices were affected by the government's removal of fuel subsidies in September 2008. Weaker domestic demand and lower commodity prices will ensure that inflation does not return to the record highs reached in 2008. Moreover, government borrowing from the SBP has fallen significantly, and this will also reduce inflationary pressures. The abatement of inflationary pressures has permitted the SBP to lower its benchmark interest rate and further reductions are expected in the future. The EIU expects that the rate of inflation will continue to fall, dropping from 20% in 2008 to 13% in 2009 and 6% in 2010.

The Pakistan rupee depreciated by 13.7% against the US dollar in 2008, reflecting investors' fears regarding the country's poor political prospects, rising prices, and the weakening economy. However, the rate of depreciation slowed following finalization of the IMF stand-by arrangement in November 2008, which forestalled a balance of payments crisis. The EIU expects the Pakistan rupee to depreciate by 14.3% in 2009, then fall by only 1% in 2010. The rupee's prospects have been strengthened by the IMF financing package, but the risks to the forecast are on the downside.

Parliament approved the budget for FY 2009/10 on June 25 after considerable debate, which brought out significant resistance to additional revenue measures. The introduction of a carbon surcharge, although ultimately passed, proved particularly contentious. The budget foresees a deficit equivalent to 4.9% of GDP, up from the 4.6% agreed to with the IMF in May. Higher spending to assist the IDPs is expected to be financed by additional IDP-related external grants. Donor support has created room for relaxing the fiscal deficit target for FY 2009/10, while maintaining the course of macroeconomic stabilization. The IMF recently approved augmented credit access equivalent to $1.4 billion to be used to finance priority spending until the disbursements of donor support for 2009/10 pledged at the Tokyo donors' conference are received.

The approved budget for 2009/10 reflects modest efforts to bolster revenues and new expenditure priorities. While the budget provides for more than a dozen tax policy measures, their impact on total revenue is relatively small. Looking ahead, the government renewed its commitment to press ahead with the introduction of a broad-based value added tax in 2010/11. The VAT is regarded as the key to achieving something closer to fiscal balance in the medium term. Besides increasing expenditure on services for the IDPs, the 2009/10 budget raises development spending (also donor-supported), provides subsidies for several key industries, and increases civil servants' salaries by 20%. Wages for security forces involved in the anti-terrorism campaign are to be doubled.

Pakistan's export performance is weak and relies too heavily on textiles. The sector has been performing poorly and a wide range of domestic factors—the ongoing power crisis, higher utility costs, and the deteriorating security environment—impede its revival. Weak global demand for Pakistani exports lead to an expectation that exports will stagnate in 2009/10. Imports are likely to recover modestly after shrinking by 9.2% in 2008/09.

Remittances from Pakistanis working overseas have continued to rise, despite the global economic recession. In July Pakistan received remittances worth a record $747 million, up from $627 million in July 2008. The government hopes to double remittance inflows over the next 2-3 years. To help to achieve this ambitious goal, the government launched the Pakistan Remittance Initiative in August. It offers more favorable exchange rates and credit access to overseas Pakistanis remitting funds. The government is also planning to provide incentives for overseas Pakistanis to invest in Pakistan.

Deregulation to improve the business environment could improve private sector performance if other factors become more favorable. Pakistan's ranking on the ease of doing business index in the World Bank's *Doing Business 2010* is 85th out of 183 countries—far better, for example, than India's ranking of 133rd. Nevertheless, the country ranked poorly on certain aspects of business regulation: enforcing contracts (158th), employing workers (146th), paying taxes (143rd), and registering property (118th). No reforms were reported since the 2009 report. An inordinate amount of time—560 hours per year—was said to be required for a medium-sized company to administer its tax obligations. Often-cited flaws in Pakistan's business environment involve widespread corruption and weak infrastructure, especially power supply.

The United States is heavily involved in Pakistan. U.S. Government policy on Pakistan is based on a common interest in thwarting extremism. It encompasses both military strikes on suspected Islamist militants and development assistance, while also seeking cooperation and accountability from Pakistan. Congress recently approved $7.5 billion in aid to be spread over the next five years. The Zadari administration has touted the new aid commitment as a triumph while its critics charge that the legislation impinges on Pakistani sovereignty.

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